BILL ANALYSIS

2007-SVxz-1: IRC Update

Committee:	Revenue Laws Study Committee	**Date:**	January 12, 2007
Introduced by:		**Summary by:**	Heather Fennell Committee Counsel
Version:			

***SUMMARY:** This proposal would update the reference to the Internal Revenue Code used in defining and determining certain State tax provisions.*

CURRENT LAW: North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.[1] The General Assembly determines each year whether to update its reference to the Internal Revenue Code.[2] Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State law tracks federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made.

BILL ANALYSIS:

IRC Update

This bill would change the reference date to January 1, 2007, effective when the bill becomes law. Changing the reference date to January 1, 2007 would incorporate the changes made in the following acts: the Deficit Reduction Act of 2005, the Tax Increase Prevention and Reconciliation act of 2005, the Heroes Earned Retirement Opportunities Act, the Pension Protection Act of 2006, and the Tax Relief and Health Care Act of 2006.

Between January 1, 2006 and December 20, 2006 there were five major pieces of federal legislation that made changes to the Internal Revenue Code. This federal legislation includes the Deficit Reduction Act of 2005 (P.L. 109-71) signed into law February 9, 2006, the Tax Increase Prevention and Reconciliation act of 2005 (P.L. 109-222) signed into law May 18, 2006, the Heroes Earned Retirement Opportunities Act (P.L. 109-227) signed into law May 23, 2006, the Pension Protection Act of 2006 (P.L. 109-280) signed into law August 19, 2006 and the Tax Relief and Health Care Act of 2006 (P.L. 109-432) signed into law December 20, 2006.

[1] North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

[2] The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation … shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would … be invalidated as an unconstitutional delegation of legislative power."

Deficit Reduction Act of 2005 (P.L. 109-171)

Although this act makes numerous tax changes at the federal level, these changes have little to no direct impact at the state level.

Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222)

- *Amortization treatment of musical compositions.* Under current law, taxpayers are allowed to recover, through annual depreciation deductions, the costs of certain property used in a trade or business or for the production of income. The costs associated with the creation or acquisition of musical compositions may be depreciated using the income forecast method. Under this method, the depreciation is determined by multiplying the adjusted basis for the property by the proportion the income generated by the property during the tax year to the total forecasted income for the property for ten years. A "look-back" method is used to recapture any underpayment created by forecasting. In the third and tenth year, actual income of the property is used to determine what the taxpayer's deduction should have been if the forecast method was not used. If the forecasted income is within 10 percent of the estimated income in these years, the "look-back" method does not need to be applied.

  Under the act, expenses incurred for the creation or acquisition of musical compositions may be amortized over five years. Taxpayers can elect to amortize these expenses or use the previous forecast method. This provision applies to tax years beginning after December 31, 2005 and before January 1, 2011.

- *Amortization treatment of G & G expenditures.* The geological and geophysical (G &G) costs incurred for the purpose of accumulating data to serve as the basis for the decision about acquisition or retention of mineral rights by taxpayers in the business of exploring for minerals (including gas and oil) were previously considered capital expenditures and allocated to the property (or properties) purchased as a result of this data. If no property was purchased, these costs were taken as a loss in the year the project was abandoned. Last year, the Energy Tax Incentive Act of 2005 allowed these expenses to be amortized over two years.

  The act allows for these costs to be amortized over five years for large integrated oil companies. Large integrated oil companies are defined as companies that have an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, gross receipts in excess of $1 billion in the last taxable year ending during calendar year 2005, and an ownership interest in a crude oil refiner of 15 percent or more. This provision is effective for tax years beginning after August 8, 2005.

- *Extension of taxation of passive income of minors.* Special rules apply to the unearned income of a child who is under age 14. The special tax, colloquially called the "kiddie tax," is applied if: 1) the child has not reached the age of 14 by the close of the taxable year; 2) the child's unearned income was more than $1,700; 3) the child is required to file a return for the year. The tax applies regardless of whether the child may be claimed as a dependent on the parent's return. For children under age 14, unearned income is taxed at the parent's rate if the parent's rate is higher than the child's rate. The remainder of a child's taxable income is taxed at the child's rates, regardless of whether the tax applies to the child.

The act expands the rule to include all minors under the age 18 in the "kiddie tax." There is an exception for distributions from certain qualified disability trusts. The minor child tax does not apply to a child that is married and files a joint tax return. This provision applies to taxable years beginning after December 31, 2005.

- *Increased expensing for small businesses.* Prior to the *American Jobs Creation Act of 2004,* small businesses were eligible to expense up to $25,000 of the cost of qualifying property placed in service for the taxable year. Qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $25,000 amount was reduced dollar-for-dollar by the amount by which the cost of the qualifying property exceeded $200,000. The deduction was increased to $100,000, with costs exceeding $400,000 reducing the deduction by the *American Jobs Creation Act of 2004.* This provision was set to expire for tax years beginning after December 31, 2006.

This act extends the enhanced small business expensing thresholds until tax years beginning after 2007 and before 2010.

- *Increased income limit for conversion of traditional IRAs to Roth IRAs.* There are two general types of individual retirement arrangements (IRAs): traditional IRAs and Roth IRAs. The total amount an individual may contribute is limited to the lesser of a dollar amount ($4,000 for 2006), or the amount of the individual's taxable income for the year. Contributions to a traditional IRA are generally deductible. Distributions from a traditional IRA are included in gross income to the extent the distributions are not attributable to a return of nondeductible contributions. Contributions to a Roth IRA are not deductible. Distributions from a Roth IRA are excludable from gross income. A taxpayer with an adjusted gross income of $100,000 or less may convert all or a portion of a traditional IRA to a Roth IRA. Married taxpayers filing separate returns may not convert a traditional IRA into a Roth IRA.

This act eliminates the income limits on conversions of traditional IRAs to Roth IRAs. The amount converted is treated as taxable income in the year it is converted; however, taxpayers who convert in 2010 and do not take distributions from the converted plan until after 2012, have the option of either recognizing all of the income in 2011 or including the income ratably over the tax years 2011 and 2012. This provision is effective for tax years beginning after December 31, 2009.

Heroes Earned Retirement Opportunities Act (P.L. 109-227)

The sole purpose of this act is to allow members of the Armed Forces serving in a combat zone to make contributions to retirement plans. Contributions to individual retirement plans are limited to the lesser of $4,000 or the individual's taxable income. Combat pay is not considered taxable income; therefore, many members of the Armed Forces are currently unable to make retirement contributions. This provision will treat combat pay as taxable income for the purposes of making contributions to an individual retirement account. This provision is retroactive to tax years beginning after December 31, 2003. This act will lower Federal and state taxable income and can result in amended returns for earlier years.

Pension Protection Act of 2006 (P.L. 109-280)

Contributions and Benefits

- *Increase in employer deduction limitations for contribution to defined benefit plans.* An employer's contributions to a qualified retirement plan are generally deductible, but the amount that qualifies for the deduction is limited. Under the level funding method, the limitation on the amount of deductible contributions is the amount necessary to provide the remaining unfunded cost of the participant's past and current service credits distributed as a level amount of the remaining future service of each participant. Under the normal cost method, the limitation on the amount of deductible contributions is the amount equal to the normal cost of the plan, plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount necessary to amortize the unfunded costs attributable to such credits in equal annual payments over ten years. Regardless of the type of defined benefit plan, the maximum limitation for contribution deductions cannot be any less than the unfunded current liability.

  The act increases the deduction limits for contributions to defined benefit plans with different limits placed upon single-employer plans, multiemployer plans, and combined plans.

  > Single-employer plans: For years beginning in 2006 and 2007, the maximum deduction limitation cannot be any less than the unfunded current liability. However, when calculating unfunded current liability a single-employer plan subtracts the value of the plan's assets from 150 percent of the current liability of the plan. In years beginning after December 31, 2007 the annual deduction limitation is the greater of 1) the minimum contribution or 2) the excess of the sum of: (i) the funding target for the plan year, (ii) the target normal cost for the plan year, the "cushion amount" for the plan year; over the value of the assets held in the plan. For plans that are not "at risk," the cushion amount is removed from the computation in (ii). The "cushion amount" is generally the sum of 50 percent of the funding target for the plan year and the amount by which the funding target would increase for the year if the plan took into account expected future increases in compensation or, if the plan does not base benefits for past service on compensation, expected increases in benefits in succeeding plan years.
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  > Multiemployer plans: For years beginning in 2006 and 2007, the maximum amount of the deduction limitation for contributions to multiemployer plans cannot be less than 140 percent of the current liability of the plan minus the plan's assets. For years beginning after December 31, 2007, the formula for the deduction is the same, but benefits that are nonforfeitable under the plan after termination of the plan should not be taken into account in computing the current liability of the plan.
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  > Combined plans: The deduction limit for combined plans only applies to contributions that exceed six percent of the compensation otherwise paid or accrued to the beneficiaries under the plan year.

- *Increased IRA contributions for individuals affected by employer's bankruptcy.* Both traditional and Roth IRAs are subject to annual contribution limits. For 2006 the annual limit is lesser of $4,000 or the individual's taxable income. Individuals who have reached the age of 50 are allowed to make annual "catch-up" contributions. The annual limit on "catch-up contributions is $1,000.

The act provides employees affected by an employer's bankruptcy the option to make additional contributions to an IRA. For the years 2007 – 2009, increased contributions up to an additional $3,000 per year over the yearly contribution limit are allowed for individuals affected by an employer's bankruptcy. All of the following requirements must be met:

1) the employee must have participated in the employer's 401(k) plan on the date six months preceding the employer filing for bankruptcy:
2) the employer matched at least 50 percent of the employee's contribution with employer stock:
3) the employer is a debtor in bankruptcy in a preceding tax year:
4) the employer or any other person must have been subject to an indictment or conviction in a preceding tax year resulting from business transactions related to the bankruptcy case.

Health and Medical Benefits

- *Health insurance premiums for retired public safety officers.* Distributions from a qualified retirement plan are generally included in taxable income the year of the distribution except to the extent attributable to after-tax contributions.

Retired public safety officers may exclude from taxable income up to $3,000 of otherwise taxable distributions from a government pension if used to pay for health insurance premiums. The individual must have separated from service either due to disability or by reaching normal retirement age. The term "public safety officer" is defined using the *Omnibus Crime Control and Safe Street Act of 1986* definition rather than the definition of public safety officer used in other provisions of the PPA. [3] This provision is effective for tax years beginning after December 31, 2006.

Plan Distributions and Rollovers

- *Modification of hardship and unforeseen financial emergency rules.* Currently, early distributions from 401(k) plans, tax sheltered annuities, 457 plans or nonqualified deferred compensation plans are allowed for hardship and unforeseen financial emergencies of the individual plan participant, or the individual's spouse or dependent.

The act directs the Secretary of Treasury to modify regulations for determining whether a participant has had a hardship or unforeseen financial emergencies for purposes of receiving an early distribution from a qualified retirement plan. The new regulations must provide that a hardship or unforeseen financial emergency of any beneficiary of a plan participant, regardless of the beneficiary's relationship to the plan participant, qualifies for an early distribution. This provision is considered effective after August 17, 2006.

[3] Under the Omnibus Crime Control Act a "public safety officer" includes an individuals who 1) are involved in crime control or reduction, or enforcement of criminal laws, including but not limited to police, corrections, probation, parole and judicial officers; 2) professional firefighters; 3) officially recognized or designated public employee members of a rescue squad or ambulance crew; 4) officially recognized or designated members of a legally organized volunteer fire department; and 5) officially recognized or designated chaplains of volunteer fire departments, fire departments, and police departments.

- *Treatment of certain distributions to public safety employees.* Unless an exception to the penalty applies, distributions from a qualified retirement plan prior to age 59 ½, death or disability of a plan participant, are subject to a 10% early withdrawal penalty.

Under this act, the early withdrawal penalty will not apply to distributions from a government plan to a qualified public safety employee who separates from service after the age of 50. A qualified public safety employee is "any employee of a State or political subdivision of a State who provides police protection, fire-fighting services, or emergency medical services for any area within the jurisdiction of the state or political subdivision." This provision is considered effective after August 17, 2006.

- *Treatment of distributions to individuals called to active duty in excess of 179 Days.* Unless an exception to the penalty applies, distributions from a qualified retirement plan prior to age 59 ½, death or disability of a plan participant, are subject to a 10% early withdrawal penalty.

Under this act, the early withdrawal penalty will not apply to distributions to a qualified reservist if the reservist or national guardsman is ordered or called to duty for a period in *excess* of 179 days or for an indefinite period.[4] To qualify for the exception to the penalty, the distribution must be made during the period from when the reservist was called to duty and the close of active duty. The individual may repay the amount withdrawn up to two years after the end of active duty. Limitations on IRA contributions are lifted for this two year period of repayment, but no deductions can be taken for contributions made for repayment purposes. This provision applies to distributions made after September 11, 2001.

- *Direct rollovers from eligible retirement plans to Roth IRAs.* Previously, distributions from tax-qualified retirement plans, tax-sheltered annuities and section 457 plans could be not be directly rolled into a Roth IRA. These distributions could only be rolled into a Roth IRA by first rolling the distributions into a traditional IRA and then into a Roth IRA provided the individual met the additional limitations on rolling over a traditional IRA into a Roth IRA.

The act provides that starting in January 2008, distributions from tax-qualified retirement plans, tax-sheltered annuities and section 457 plans can be rolled directly into a Roth IRA. For tax years prior to January 1, 2010, taxpayers with adjusted gross income less than $100,000 and either single or married filing jointly are allowed to rollover a traditional IRA to a Roth IRA. For later tax years, the income limit is eliminated (see *Tax Increase Prevention and Reconciliation Act of 2005*). This provision applies to distributions after December 31, 2007.

- *Rollovers by nonspouse beneficiaries.* Generally, distributions from tax-qualified retirement plans, tax-sheltered annuities and section 457 plans are taxed in the year distributed. Certain eligible distributions can be rolled over to eligible retirement plans, tax free, within 60 days of the distribution. A surviving spouse beneficiary of a plan participant can roll over distributions from the decedent's plan as if the surviving spouse were the original plan participant.

This act provides that nonspouse beneficiaries can now rollover the distributions of a decedent's eligible retirement plan tax-free into an IRA via a trustee-to-trustee transfers. However, the new

[4] "Short tour opportunities" defined by military guidelines are 179 days *or less*.

IRA is treated as an inherited account (no further rollovers allowed), and required minimum distribution rules apply. This provision is effective for distributions after December 31, 2006.

Charitable Contributions

- *Tax-free IRA distributions to charities.* Generally, to make a charitable donation from an IRA, a distribution must be taken and the applicable rules regarding taxable income apply. The distribution is included in taxable income to the extent the distributions are not attributable to a return of nondeductible contributions. The standard charitable deduction rules then apply to the donation.

This act provides that individuals 70 ½ or older can now distribute up to $100,000 per taxable year from their IRAs to charitable institutions without recognizing the income. The distribution must be made directly to the charitable organization from the trustee. This distribution counts towards the required minimum distribution. The provision is effective for distributions made after December 31, 2005 and before January 1, 2008.

- *Charitable contributions of clothing and household items.* The charitable deduction of noncash property is generally the property's fair market value. For contributed items used in a manner unrelated to the donee's exempt purpose, the deduction is generally the donor's basis in the item. For donations of clothing and household items with a value of less than the original basis, most taxpayers deduct the fair market value of the item.

The act provides that contributions of clothing or household goods are limited to items that are in "good" used conditions or better unless the deduction for a single item exceeds $500 and the taxpayer includes a qualified appraisal. This provision applies to contributions made after August 17, 2006.

- *Charitable Contributions of Taxidermy Property*. The charitable deduction of noncash property is generally the property's fair market value. For contributed items used in a manner unrelated to the donee's exempt purpose, the deduction is generally the donor's basis in the item.

The act provides that the charitable deduction allowed for contributions of taxidermy property is the lesser of either the donor's basis in the property, or the fair market value of the property. In determining the donor's basis in the property, only direct costs paid or incurred by the donor for preparing, stuffing, or mounting the property are included.

- *Real property contributions for conservation.* The deduction for capital gain appreciated real property is generally limited to 30 percent of the donor's adjusted gross income if the donor uses the fair market value of the donated property. If the donor's basis is used as the value of the property, and the property is donated to a "maximum deduction" organization, the deduction is limited to 50 percent of the donor's adjusted gross income.[5] Deductions for donations to non-

[5] Maximum deduction organizations include public charities, private operating foundations, private non-operating foundations that distribute contributions within two and one-half months of the year's end, and private non-operating foundations that maintain a common fund.

maximum donation organizations are limited to 20 percent of the donor's adjusted gross income. Contributions that exceed the deduction limit can be carried forward for five years.

The act changes the deduction for donations of conservation easements. An individual may deduct the value of the easement, based on fair market value, up to 50 percent of adjusted gross income, with a 15-year carryforward for any excess. A "qualified farmer or rancher" may deduct the value of the gift up to 100 percent of adjusted gross income with a 15-year carryforward. A "qualified farmer or rancher" is an individual whose gross income from the trade or business of farming is greater than 50 percent of the taxpayer's gross income for the tax year. The land donated by a farmer or rancher also must "be available" for agricultural use, but it need not be used for that purpose. This provision applies to contributions made in tax years beginning after December 31, 2006.

- *Charitable contributions of façade easements.* A façade easement is a real property contribution for conservation that can be used to preserve the architectural, historic and cultural features of the façade of a building. Homes listed in either the National Register of Historic Places or located in a historic district and certified by the National Park Service as being of historical significance to the district qualify for this treatment.

The act allows for deductions for charitable contributions of façade easements of private residences only if the residence is listed individually in the National Register of Historic Places. For properties that are located in a historic district and certified by the National Park Service as being of historical significance to the district, the charitable deduction is allowed only if the restrictions relate to the entire exterior of the building, including the space above the building, the sides, the rear and the front of the building. The deduction for all properties is reduced to take account any rehabilitation credit previously claimed. The deduction for the façade easement is reduced by the percentage the rehabilitation credit represents of the fair market value of the home. This provision applies to contributions made after August 17, 2006.

- *Charitable deduction for contribution of food inventories.* A taxpayer's deduction for charitable contributions of inventory is generally limited to the lesser of the taxpayer's basis in the inventory (usually cost) or the fair market value of the inventory. For certain contributions of inventory, a C corporation may claim an enhanced deduction equal to the lesser of 1) basis plus one-half on the item's appreciation or 2) two times basis. To be eligible for the enhanced deduction, the contributed property must generally be inventory of the corporation, contributed to a charitable organization described in section 501(c)(3) of the Code, and the donee must 1) use the property consistent with the donee's exempt purpose only for the care of the ill, the needy, or infants, 2) not transfer the property in exchange for money, other property, or services, and 3) provide the taxpayer with a written statement attesting to the proper use of the property.

This act allows the enhanced deduction to any taxpayer engaged in a trade or business that makes a donation of food inventory. For taxpayers other than C corporations, the total deduction for contributions of food inventory may not exceed 10% of the taxpayer's income from all business entities from which a contribution of food inventory is made. The enhanced deduction is available only for food that qualifies as "apparently wholesome food," – food intended for human consumption that meets all quality and labeling standards imposed by federal, state, and local laws even though the food may not be readily marketable for any number of reasons. The act extends for two additional years the enhanced deduction for the charitable deduction for contribution of food inventories. This provision is now set to expire for contributions made after December 31, 2007.

- *Charitable deduction for contribution of book inventories.* A taxpayer's deduction for charitable contributions of inventory is generally limited to the lesser of the taxpayer's basis in the inventory (usually cost) or the fair market value of the inventory. For certain contributions of inventory, a C corporation may claim an enhanced deduction equal to the lesser of 1) basis plus one-half on the item's appreciation or 2) two times basis. To be eligible for the enhanced deduction, the contributed property must generally be inventory of the corporation, contributed to a charitable organization described in section 501(c)(3) of the Code, and the donee must 1) use the property consistent with the donee's exempt purpose only for the care of the ill, the needy, or infants, 2) not transfer the property in exchange for money, other property, or services, and 3) provide the taxpayer with a written statement attesting to the proper use of the property.

This act extends the enhanced deduction for C corporations to qualified book contributions. A "qualified book contribution" is a charitable contribution of books to a public school that provides elementary education or secondary education and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils in attendance at the place where its education activities are regularly carried on. The act extends for two additional years the enhanced deduction for the charitable deduction for contribution of book inventories. This provision is now set to expire for contributions made after December 31, 2007

Tax Relief and Health Care Act of 2006 (P.L. 109-432)

Extension of prior provisions:

This act extends for two years, until the tax year ending December 31, 2007, the following provisions:

- *Above the line deduction for higher education expenses.* Under prior law, individuals were allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year. The maximum deduction is $4,000 for an individual whose adjusted gross income for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $42,000 for other individuals whose adjusted gross income does not exceed $80,000 ($160,000 in the case of a joint return). This deduction was available for tax years beginning prior to December 31, 2005.

This provision is extended for two years, until the tax year ending December 31, 2007.

- *Deduction of state and local general sales taxes.* The American Jobs Creation Act (ACJA) of 2004 allowed taxpayers to deduct state and local sales taxes in lieu of deducting state and local income taxes, real property taxes, and personal property taxes. This provision became effective with the 2004 taxable year and was set to expire for tax years beginning in 2006 and thereafter. This provision extends the deduction for two years, through December 31, 2007.

The General Assembly did not conform to this change under the ACJA. In order to allow this deduction for North Carolina income tax purposes, affirmative action must be taken to conform to the initial change as well as the extension of the provision as provided in this act. The current bill takes no action on this matter.

- *Above the line deduction for qualified expenses of elementary and secondary school teachers*. Under prior law, an eligible educator was allowed an above-the-line deduction of up to $250 for amounts paid by the teacher for books or supplies used in the class room. An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during the school year. This deduction was available for tax years beginning prior to December 31, 2005.

  This provision is extended for two years, until the tax year ending December 31, 2007.

- *Fifteen-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant property.* Prior law provided for 15-year straight-line depreciation for qualified leasehold improvements to nonresidential real property placed into service after the date of enactment (October 22, 2004) and prior to January 1, 2006. A qualified leasehold improvement is an improvement made to the interior of a building by either the lessor or lessee and placed in service more than three years after the building is placed in service. Under prior law, a qualified leasehold improvement was depreciated using straight-line depreciation over a 39-year period – the same period as for depreciation of nonresidential property in general.

  A similar depreciation schedule is put into place for qualified restaurant property placed into service after the date of enactment (October 22, 2004) and prior to January 1, 2006. In order to qualify as "qualified restaurant property", the property must be a building improvement placed in service more than three years after the building is placed in service and the restaurant must use more than half of the square footage of the building. This deduction was available for tax years beginning prior to December 31, 2005.

  This provision is extended for two years, until the tax year ending December 31, 2007.

- *Enhanced deduction for the charitable donation of computer technology and equipment.* Prior law allowed an enhanced deduction for contributions of computer technology or equipment to schools or public libraries that would use the computer equipment for educational purposes. This deduction was available for tax years beginning prior to December 31, 2005.

  This provision is extended for two years, until the tax year ending December 31, 2007.

This act extends for one year, until the tax years ending December 31, 2009, the following provision:

- *Deduction for energy efficient commercial buildings.* Prior law allowed a deduction for energy efficient commercial buildings. Energy efficient expenditures are certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, and ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building. The deduction is limited to $1.80 per square foot of property for which such expenditures are made. A partial allowance of the deduction is allowed for buildings that do not meet the requirement of a 50 percent energy savings but are certified by a qualified profession as meeting or exceeding the applicable system specific savings targets established by the Secretary of the Treasury. This deduction is available for property placed in service after December 31, 2005 and prior to January 1, 2008.

This provision extends the deduction to property placed in service prior to January 1, 2009.

New provisions:

• *Change in contribution limitations for Health Savings Accounts*. Under current law individuals with a high deductible health plan may establish health savings accounts ("HSA") for the payment of current and future medical costs. Contributions to HSAs made by or on behalf of an individual are deductible by the individual. The contributions are limited to the lesser of (1) the annual deductible of the health plan or (2) $2,850 for individual coverage and 55,650 for family coverage.

The act modifies the contribution limitation for HSAs. Contributions are now limited to $2,850 for individual coverage and 55,650 for family coverage. This provision is effective for taxable years beginning after December 31, 2006.

• *Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico.* Present law provides a deduction from taxable income that is equal to a portion of the taxpayer's qualified production activities income in the United States. For the taxable year beginning in 2006 the deduction is three percent of income. For the taxable year beginning in 2007 the deduction is six percent of income. Currently, Puerto Rico is not in the definition of the United States.

The act includes Puerto Rico in the definition of the United States for the purposes of determining domestic production activities, but only if all of the taxpayer's gross receipts from sources within Puerto Rico are currently taxable for U.S. Federal Income tax purposes. This provision is effective for the first two taxable years beginning after December 31, 2005, and before January 1, 2008.

• *Deduction for premiums for mortgage insurance.* Present law provides for a deduction for qualified residence interest. The maximum amount of home equity indebtedness is $100,000. The maximum amount or acquisition indebtedness is $1 million. The act provides that premiums paid for mortgage insurance on a qualified residence of the taxpayer are treated as interest that is qualified residence interest and thus deductible. The amount allowable as a deduction under the provision is phased out ratably by 10 percent for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000 ($500 and $50,000 respectively, in the case of a married individual filing a separate return). The deduction is not allowed if the taxpayer's adjusted gross income exceeds $110,000 ($55,000 in the case of a married individual filing a separate return).

This provision does not apply with respect to any mortgage insurance contract issued before January 1, 2007. The provision terminates for any amount paid or accrued after December 21, 2007, or property allocable to any period after that date.